

# NEW PRIIPs REGULATION: WAITING FOR GODOT ?

## INTRODUCTION

Since the very first discussion paper on PRIIPs in 2014, several documents on this regulatory topic saw daylight: consultation documents (2019, 2018), consumer testing (2019 and 2015), technical standards (2016 and 2018) and a set of Q&A-releases (2017, 2018 and 2019).

The flaws of the regulation were recognized by both the industry and the regulators and were the topic of the latest consultation document prepared by the ESAs in October 2019. The feedback of the industry would be used by the ESAs to amend the current regulatory technical standards (RTS) where needed. This was an expected and important change given the fact that UCITS funds will be subject to the PRIIPs regulation from January 1, 2022 onwards.

The KID manufacturers were surprised on July 20th, 2020 to witness EU regulators “to agree to disagree”. This is the first time that EU regulators have failed to endorse their own technical standards. The letter of the ESAs illustrates how difficult it has been for policymakers to rectify some of the pitfalls in their own regulation.

As things stand, nothing has changed and the production of the KID documents will continue to follow the same process according to the current technical standards. The saga of misleading performance scenarios, incomprehensive intermediate scenarios for structured notes and pitfalls in the transaction cost calculation continues.

The regulators wrote in their letter to John Berrigan, director general of the Financial Stability, Services and Capital Markets Union (FISMA), that they were “not in a position to formally submit” a final proposal. They nevertheless published a draft of the new RTS. This is an interesting document which we are going to study in this white-paper. Even if this ‘failed’ draft has no direct impact on any of the current work of PRIIPs manufacturers, it is important to understand what was on the drawing board. The vote for this new regulatory technical standard was a near miss. The securities market regulator (ESMA) and banking regulator (EBA) supported the new RTS, but some members of the board of the European insurance watchdog (EIOPA) did not back this new plan.

## TIMING

The feedback received from the stakeholders on the 2019 consultation document made it clear that the industry prefers a single regulatory update (including a review of the Level 1

regulation) instead of a series of minor changes. Such an overhaul of the RTS should ideally have been scheduled to coincide with the introduction of UCITS funds into the KID-landscape (January 1st, 2022). Originally the ESAs favored a gradual approach, where the regulation would be changed and updated in a gradual way.

## CHANGES IN THE PIPELINE

In summary, the amending RTS included proposals in the following main areas:

- SRI Overload
- New methodologies for performance scenarios
- Revised presentation of the scenarios
- Revisions to the summary cost indicators and changes to the content and presentation of information on the costs of PRIIPs
- Modifications to the methodology to calculate transaction costs
- Refinements to the rules for PRIIPs offering a range of options for investment (MOPs)
- The requirement for certain types of investment funds and insurance-based investment products to publish information on the past performance of the product

The draft report proposes as well several amendments to the PRIIPs Regulation (Level 1).

### SRI – OVERLOAD (ANNEX II)

A new article (52-a) was introduced in Annex II of the RTS and allows the manufacturer to present a higher SRI than what is calculated by the regulatory formula.

## NEW METHODOLOGIES FOR PERFORMANCE SCENARIOS (ANNEX IV)

### FEEDBACK FROM THE OCTOBER 2019 CONSULTATION

The Achilles heel of the risk and performance formulas supporting the KID was their high dependency on the historical growth rate obtained from the timeseries of the fund (or its benchmark/proxy). For non-structured investment funds, this could lead to favourable scenarios with a return above 100%, hereby implicitly suggesting a capital guarantee. In a period following a market downturn (such as Q2-2020), several favourable scenarios produce a negative outcome together with the unfavourable, moderate and stressed scenarios. As such the investor is presented a KID only promising losses to an investor! As suggested in the 2019 consultation, replacing the growth rate by a well-chosen risk premium could move this procyclicality off the table.

The use of these risk premia was not considered viable by many respondents. Other approaches, such as the use of implied volatility to calculate scenarios for money market funds was moved off the table as well. These new methods indeed increase the dependency

on external data to be purchased from data vendors. This would turn the KID production process into a costly exercise.

## ESAS DID MORE TESTING

The ESAs have expanded their testing of the current and new methodology on a much wider range of instruments. For 775 PRIIPs the realized future performance was compared to what was actually present in the outcome of risk and performance calculations 5 years earlier. The sample PRIIPs on which the exercise was run contained structured notes, structured deposits and investment funds.

Other, more indirect calculation approaches were also being considered to eradicate the procyclicality effect of the growth rate of a PRIIP. One method introduced for example the use of an asset specific growth rate. A second indirect calculation method relied on the use of a benchmark-index.

## PROPOSED METHODOLOGY

For investment funds (UCITS and AIFs, except structured UCITS and structured AIFs) and other Category 2 PRIIPs, such as unit-linked insurance-based investment products, the ESAs proposed a new methodology. This resulted in a complete re-write of Appendix IV of the RTS.

A closed form formula as currently is the case, would no longer be allowed in the generation of the performance tables. Instead the ESAs present performance scenarios (unfavourable, moderate and favourable) based on a range of future outcomes that are more direct estimates from a distribution of past returns of the PRIIP (or a relevant benchmark) at different points in time in the past. The best, average and worst performances would be shown under certain parameters. The calculation of the scenarios can be summarized in 6 steps:

1. Determine the period ( $T_{calc}$ ) over which the different price returns are to be calculated. The length of this period depends on the recommended holding period but shall not be smaller than 10 years:
 
$$T_{calc} = \max[10 \text{ year}, RHP + 5 \text{ year}]$$
2. Divide the time-frame  $T_{calc}$  in overlapping intervals  $\Delta t_{a,i}$  with length equal to the RHP
3. For PRIIPs with an RHP > 1 year, determine the overlapping sub-intervals individually equal or shorter in length to the duration of the recommended holding period, but equal to or longer than one year ( $\Delta t_{b,i}$ ).
4. Moderate Scenario: rank the price return of the intervals  $\Delta t_{a,i}$  and calculate the medium return
5. Favourable Scenario: rank the price return of the intervals  $\Delta t_{a,i}$  and determine the best observed return
6. Unfavourable Scenario: rank the price return over  $\Delta t_{a,i}$  and  $\Delta t_{b,i}$ <sup>1</sup> and calculate the worst return.

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<sup>1</sup> The returns in  $\Delta t_{b,i}$  have to be adjusted linearly to the recommended holding period.

## CATEGORY 2 PRIIPs WITHOUT SUFFICIENT HISTORICAL DATA

- If the PRIIP is using a benchmark, the benchmark data can be used to supplement the time series in order to have at least the 10-year data.
- If there is no benchmark for the PRIIP or where the benchmark has no sufficient data, a different approach has to be chosen. A benchmark regulated by Regulation (EU) 2016/1011<sup>2</sup> that represents the asset classes in which the PRIIP invests has to be used.
- If the PRIIP invests in different asset classes, a so-called compound benchmark can be constructed.
- In absence of a benchmark an appropriate proxy can be chosen.
- Article 16 of the draft RTS describes different eligibility criteria to be considered by the manufacturer of the fund when introducing a benchmark or proxy for the performance scenarios

## INTERMEDIATE SCENARIOS

The number of intermediate scenarios required in the KID depends on the length of the recommended holding period RHP:

- **RHP>10**  
Present a performance scenario for 3 periods: 1 Year, RHP and RHP/2 (rounded up to the end of the nearest)
- **1<RHP≤10**  
Present a scenario at the end of the first year and the RHP
- **RHP≤1**  
Present a scenario for the RHP only.

The price returns for the intermediate scenarios will be calculated using appropriate time intervals ( $\Delta t_i$ ). The scenarios are presented both as annualized percentages and in monetary units. The presentation of the monetary outcome is slightly different from what is present in the current RTS. The different results are to be rounded up to the nearest 10 EUR in the relevant PRIIP currency.

The calculation approach for the stressed scenarios has a minor change in Article 18d of Annex IV. There also the introduction of Article 20 imposing a cap on the outcome of the stressed scenario. This outcome shall not be better than the value of the unfavorable scenario.

For the other PRIIPs the approach remains unchanged, but KID manufacturers are allowed in some cases to calculate scenarios using lower percentiles than what is expected. This allows them to present more conservative outcomes where required. Such an intervention can only be done when the PRIIP manufacturer considers there is a material risk that the scenarios, as prescribed, may lead to inappropriate expectations by the investor.

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<sup>2</sup> European Benchmark regulation

## REVISED PRESENTATION OF THE SCENARIOS (ANNEX V)

This annex also got a complete rewrite and is different from the current version of the RTS. In part 2 of this annex, the different composing elements (A to K) are described. Without going into too much detail, a remarkable change is the fact that the more complicated instruments (category 1 & 3) require a brief description of the scenarios in plain language. For category 2 PRIIPs, reference will have to be made to the benchmark used (if any). Another novelty is the proposed inclusion of a minimum return. The findings from the consumer testing suggested that the inclusion of information on the minimum return level results in an improved understanding of the features of the product.

## TRANSACTION COST METHODOLOGY

In the current version of the RTS, the methods imposed for the transaction costs calculation are either the arrival price method or the new PRIIPs approach<sup>3</sup>. In some well-defined cases the mid-market price can be replaced by the opening price of the same day or the prior closing price.

Sourcing this mid-market price can be a costly exercise since this involves sourcing tick history data from one or more vendors. The newly proposed draft would allow to use the half-spread method. This would be the case when the fund has a low number of transactions or where the total value of these transactions only account for a small percentage of net assets of the fund. Unfortunately the threshold is not specified and seems to be left open for interpretation.

Another interesting point is the fact that UCITS funds can calculate the transaction costs until December 2024 using the new PRIIPs method. This means that there is a 3-year period during which they will not have to worry about how to adjust their IT systems to capture the arrival price. As a consequence, this will soften the onboarding pain for UCITS managers when moving to the PRIIPs regime.

## CONTENT AND PRESENTATION OF PAST PERFORMANCE INFORMATION (ANNEX VIII)

This is a brand-new annex incorporated into the draft regulatory standards. Annex VIII specifies how and when past performance data can be added to a KID. The majority of respondents from the UCITS industry to the consultation document were in favor of the presentation of past performance. This was primarily the case for equity funds. Managers of bond funds, real estate funds and representatives from the insurance industry were not in favor of this inclusion.

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<sup>3</sup> This method is also known as the half spread method.

The past performance has to be included for category 2 PRIIPs in the form of a bar chart. The layout and specifications of this bar chart are described in the new RTS. When a UCITS fund or AIF make use of a benchmark, the past performance of this benchmark is to be included in the bar chart.

KID manufacturers can describe, if necessary and in plain language, a warning regarding the lack of representativeness of this past performance chart. The presented past performance shall include a period of the last 10 years of the fund. In some cases, such as new share class launches, simulated performance can be recorded based on a similar share class with a longer existence.

The debate on past performance evolved around the inclusion of this information in the KID or its publication as a separate document. Such a separate document would then be referenced in the “Other relevant information” section of the KID.

## CONCLUSION

Even if this RTS got stuck on the drawing board and failed to get a formal sign off from all the ESAs, it is important to see the direction in which the regulators have been moving forward: inclusion of past performances, a new approach for scenario calculations, the revised intermediate holding periods, changes in the transaction cost calculations,...

An important take-away is the fact that the regulators were providing some flexibility to UCITS funds. The effort of UCITS Managers to onboard the KID-regulation in December 2021, was met with some flexibility in terms of transaction costs calculations. Unfortunately this version of the RTS did not get a blessing from all three ESAs

We would like to point out that there are only two blocking elements separating the current proposal from a final version where also EIOPA would find comfort. One of the two disruptive items is the fact that some argued that a partial revision of the PRIIPs Delegated Regulation is not appropriate at this stage, prior to a comprehensive review of Regulation (EU) 1286/2014 according to Article 33 of the Regulation. The second stumbling block was the way to incorporate past performance information in the KID.

Sooner or later, the proposed changes in this document will emerge again and will require a lot of flexibility when designing regulatory compliance solutions. Risk and compliance teams face an intense 2021 ahead !